MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

The almost surreal mood here in Washington these days is perhaps best illustrated by the leads to two adjacent stories on the front page of the *Washington Post* on the day after the President's State of the Union message.

The headline story began: "President Clinton appeared before a joint session of Congress last night to present an ebullient vision of a nation enjoying vast prosperity after six years under his leadership, a newfound abundance that he said should be used to prepare for the burden of a rapidly aging population in the next century." The story just next to it began: "President Clinton's legal team opened its defense case yesterday with a scathing assault on the impeachment charges against him, dismissing them as a 'witches' brew' of conjecture and 'prosecutorial fudge-making' that do not add up to high crimes and misdemeanors."

Polls show that the country is tired of the impeachment proceedings and wants the proceedings concluded. Senators -- forced to sit at their desks and appear attentive for hours on end -- also are growing restless. Yet as of this writing the end is not clearly in sight.

Unless the impeachment proceedings culminate in a bitter removal of the President, it seems likely that once the proceedings are concluded, both Republicans and Democrats will be eager to press ahead with their respective substantive legislative agendas to demonstrate to the country a return to focusing on pocketbook issues. Whether the impeachment proceedings will have so poisoned the atmosphere for cooperation or left the President in such a weakened state that little gets done this year remains to be seen. However, for planning purposes we must assume that key issues on STRS's legislative agenda, such as mandatory Social Security and Elk Hills, will be actively considered this year.

Mandatory Social Security for State and Local Government Workers

The Social Security reform debate took a significant step forward when President Clinton proposed in his January 19 State of the Union address that almost two-thirds of the projected Federal budget surpluses over the next 15 years be channeled into the Social Security trust fund with a portion of that amount to be invested in the stock market in hopes of generating higher returns. More specifically, 62 percent of the projected federal surplus over the next 15 years -- some $2.8 trillion -- would be dedicated to the trust fund. Approximately, a quarter of that surplus -- some $650 to $750 billion -- would be invested in the stock market, with the balance invested in Treasury securities. These two changes are projected to extend the solvency of the Social Security trust fund by more than 20 years, from the year 2032 to 2055.

An additional $500 billion of the surplus would be used to fund retirements accounts controlled by the individual, termed “Universal Savings Accounts”, which would operate on a basis similar to the section 401(k) plan concept. The Federal government would make a specified contribution to the participant’s account and then would provide some form of match for additional contributions by the participant, with a greater percentage match for lower-income workers. These new individual accounts would not be part of the Social Security system, but would be treated, in the parlance, as an “add-on” retirement savings program.

The Administration’s Social Security reform plan has been set forth only in the barest of outlines, pending the expected detail of the President’s budget.

The good news on the mandatory Social Security front is that the more detailed proposal in the forthcoming President’s budget reportedly will **not** include a provision mandating Social Security coverage for new State and local workers in systems that currently do not participate in Social Security. Based on this and other feedback, the message from union and employer groups in California and other affected States, as well as the national organizations of public employers and employees, about the harsh consequences of mandatory coverage for both State and local governments and their employees clearly has registered with the White House.

However, that is only the opening round on the mandatory coverage issue, and there are likely to be many more threats as the Social Security reform process moves forward. Given the course the White House took, they simply did not need our money. The size of the projected Federal budget surpluses eliminated any short-term funding concern for the reform plan. To the extent that the debate in Congress shifts in the direction of private accounts *as part of* the Social Security system, rather than as a separate “add-on” retirement savings program, the need for the upfront cash represented by mandatory State and local coverage would reappear. This upfront cash would be necessary to fill the funding void for current transfer payments to retirees that is created when a portion of current revenues is diverted to begin to fund the individual accounts for future retirees.

This concern is illustrated by the Social Security reform package just introduced by Sens. Daniel Patrick Moynihan (D-N.Y.) and Bob Kerrey (D-Neb.) (S. 21) that would operate Social Security as a pay-as-you-go system, cut payroll taxes by two percentage points, establish voluntary personal savings accounts which would be funded with the revenues from the payroll tax cut, reduce the cost-of-living allowance, tax Social Security benefits in the same manner as pension payments, and impose mandatory State and local government coverage for new hires.

As the Social Security reform debate moves forward in the Administration and on Capitol Hill, we will be continuing to work actively with other affected States and with the national organizations of public employers and employees to educate Members of Congress regarding the harsh impact on employer cost and employee benefit levels that would flow from the imposition of mandatory Social Security coverage. STRS staff has done an excellent job of marshaling the grassroots in Californian with school superintendents and employer groups and employee groups writing and calling their Members of Congress and contacting the Administration. While STRS staff is in Washington this week, we will having a series of meetings with the offices of key Members of the California Congressional delegation from both parties. A group of 19 Democratic House Members from California, including Rep. Bob Matsui (D-Sacramento) who is the ranking Democrat on the House Ways and Means Social Security Subcommittee, sent a letter to the President strongly opposing any effort to impose mandatory Social Security on State and local workers.

The response to the President's outline of a Social Security reform plan has been mixed. House Ways and Means Chairman Bill Archer (R-Tex.) has accepted the President's proposal to commit 62 percent of the projected budget surpluses over the next 15 years to bolstering Social Security, but strongly criticized the President's proposal to directly invest Social Security trust fund monies in the stock market. Ways and Means Chairman Archer is a strong proponent of using individually-controlled investment accounts as part of the Social Security system itself, rather than as a separate "add-on" retirement savings program. He expressed concerns about the potential for political interference and the implications for other areas of Federal government policy, such as antitrust, if the government were to have a direct equity position, by way of the Social Security trust fund, in particular companies. Preliminary estimates of the President's proposal are that by the end of the 15-year period, the Federal government would own about 4 percent of the total U.S. equities market.

Federal Reserve Board Chairman Alan Greenspan criticized the proposal to shift Social Security trust fund investments from Treasury securities to private equities, and specifically criticized the use of direct investment by the Federal government. Chairman Greenspan expressed concern over the difficulty of shielding investment managers for the Federal government from political interference and pointed to the State and local government pension sector in particular, where he noted that the investment performance of State and local systems in general lags behind private pension fund performance, suggesting that political interference may have played a role in this disparity.

Elk Hills Compensation

Recognizing that mandatory Social Security remains the top Federal legislative priority for STRS this year, we will be continuing to work with Rep. Bill Thomas (R-Bakersfield) and key Members of the California Congressional delegation in the coming year to secure the Congressional appropriation that is necessary to fund the second $36 million installment of Elk Hills compensation for STRS. Unless we undertake an active legislative effort, it is unlikely that the $36 million appropriation for the second installment would be forthcoming.

We already have been working with Rep. Thomas's office in planning strategy for the new legislative session. At Rep. Thomas's request, STRS staff prepared very useful illustrations of the increase in pension that has arisen from the increase in the purchasing power allowance funded by the Elk Hills compensation for sample retirees in each California Congressional district.

Rep. Thomas will shortly be circulating to his colleagues in the California delegation a letter to the Chairman of the House Appropriations Committee, Rep. C.W. "Bill" Young (R-Fla.), seeking the appropriation for the second $36 million installment of Elk Hills compensation. As we did last year, we will be seeking to have the entire California Congressional delegation sign on to the letter.

With the retirement of Rep. Vic Fazio (D-Sacramento), we have lost our strongest ally on the Appropriations Committee and on the Democratic side. California Members of the House Appropriations Committee now include Reps. Jerry Lewis (R-Redlands), Ron Packard (R-San Clemente), and Duke Cunningham (R-Escondido) on the Republican side, and Reps. Julian Dixon (D-Los Angeles), Nancy Pelosi (D-San Francisco), Sam Farr (D-Monterey), and Lucille Roybal-Allard (D-Los Angeles) on the Democratic side. Reps. Farr and Roybal-Allard are new to the Appropriations Committee. On the Senate side, Sen. Feinstein has once again switched Committee slots with Sen. Boxer, with Sen. Feinstein returning to the Appropriations Committee. However, no

Californian serves on the Interior Appropriations Subcommittee that has actual direct jurisdiction over the Elk Hills issue on the full Appropriations Committee.

The legislative effort to secure funding of the Elk Hills compensation is likely to continue to be a difficult exercise. With the return to "regular order" in the Congressional appropriations process, the latitude we enjoyed last year in the end-of-session appropriations free-for-all will be absent. The President is expected to request the appropriation in his budget for FY 2000, to be submitted to Congress on February 1. However, both the House and the Senate Appropriations Committees historically have been hostile to the Elk Hills compensation issue.

Broad Pension Liberalization Legislation

The coming year is expected to be another active one for legislation to liberalize current law pension rules and limits.

Reps. Rob Portman (R-Ohio) and Ben Cardin (D-Md.) are expected to reintroduce their bipartisan comprehensive pension reform legislation. This legislative package is expected to include a broad range of items of interest to State and local government retirement systems, including increases in the annual limits on permissible benefits under a defined benefit plan and contributions to a defined contribution plan; increased portability by permitting workers changing jobs to roll eligible distributions among tax-qualified defined contribution and defined benefit plans, section 403(b) plans, and section 457 plans; catch-up contributions for older workers under salary reduction plans; liberalization of the section 457 plan contribution limits, and a series of other liberalizations in current law pension rules.

On the Senate side, Finance Committee Chairman William V. Roth, Jr. (R-Del.) is sponsoring the Retirement Savings Opportunity Act of l999 that would make a broad series of liberalizing changes to current pension rules. Chairman Roth's bill would expand the Roth IRA concept to the section 401(k) plan and section 403(b) plan context. Participants could choose between the traditional section 40l(k) and section 403(b) plans which are funded on a pre-tax contribution basis and "Roth" section 401(k) and section 403(b) plans which would be funded by contributions on an after-tax basis with earnings later being distributed tax-free at retirement.

The Roth legislation also would raise the section 403(b) limit on annual contributions to $15,000; eliminate the current section 415 limit on annual contributions to a defined contribution plan which now equals the lesser of $30,000 or 25 percent of compensation; permit employers to sponsor traditional

IRAs for their workers and permit employees to contribute through a payroll deduction; and permit participants aged 50 and older to make additional contributions to the plan above the current law limit.

Chairman Roth's legislation has not been scored for revenue estimate purposes, but is expected to be costly in the later years when the earnings from the "Roth-type" plans are distributed to the retiree on a tax-free basis.

John S. Stanton

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